



A Peek into Insider Trading In India and Kenya; a Critique of the Legal Regime

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ABSTRACT: This paper highlights the meaning of insider trading, the laws prohibiting the vice and the approach of the courts when handling cases involving insider trading.

Key words; insider trading, CMA- Capital Markets Authority, SEBI- Securities and Exchange Board of India.

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I. INTRODUCTION

After a company has offered its securities for sale to the public or through private placement, the securities are allotted. The securities can be shares or debentures or any other form.¹

Thereafter, the securities of the company will be traded in the secondary market. Here holders of securities can sell their securities in the stock market at any moment they wish (during the trading hours).²

This is mostly done by stock brokers. The price of securities of a company fluctuates every day. At times the price of the securities may fall or it may rise at certain time.³

When the price of the security of a certain company rises, more people tend to buy the securities of such company. If the price of securities of a company are steady and rarely fluctuate downwards, then the investors in securities tend to buy such securities because in a period of time they might reap high dividends. A continued rise of the price of securities of a company over a period of time is an indicator that the company is stable which implies that, the securities will yield higher dividends.

However, when the price of securities of a company fall over a period of time, the security holders rush to sell their securities. Most security holders want to exit the company when the prices of securities keep falling. This is the scenario in the securities markets.

The fall and rise in price are influenced by a number of factors, chief of them being demand. If there is a higher demand, the price is bound to rise and if there is a low demand, the price is bound to fall. The law of demand and supply is the chief determinant.

What leads to a rise or fall in demand for securities of a company? Apart from prevailing conditions in the global economy or the national economy, the status of the company encourages high demand or discourages demand altogether. For instance, if the management of the company (Board of directors) is removed from office or if there is an instant of wrangles in the company, this discourages investors from purchasing the securities of the company.⁴

If the company falls into bankruptcy, then security holders are likely to rush to sell the securities. At the same time prospective investors will avoid purchasing such securities.⁵ Not only that, when a company posts losses in the annual returns, then the demand for its shares is likely to fall.⁶

On the other hand, if the company appoints a chief executive of great reputation, who is held in high esteem in the corporate world, then the investors are likely to purchase more securities of the company.⁷

The most important pointer that excites investors is annual reports. The annual report of a company indicates whether the company is profitable. The report reveals the soundness of the company (financial). If the company

¹ <https://taxguru.in/company-law/private-placement-securities-under-companies-act-2013.html>

² <https://corporatefinanceinstitute.com/resources/knowledge/finance/secondary-market/>

³ <https://www.thebalance.com/why-do-stock-prices-fluctuate-356347>

⁴ <https://www.getsmarteraboutmoney.ca/invest/investment-products/stocks/factors-that-can-affect-stock-prices/>

⁵ <https://www.getsmarteraboutmoney.ca/invest/investment-products/stocks/factors-that-can-affect-stock-prices/>

⁶ <https://www.getsmarteraboutmoney.ca/invest/investment-products/stocks/factors-that-can-affect-stock-prices/>

⁷ <https://www.getsmarteraboutmoney.ca/invest/investment-products/stocks/factors-that-can-affect-stock-prices/>

posts a huge turnover, investors are likely to buy more securities of the company in the hope that they will reap huge dividends in the future.⁸

In the recent times, it has been a common practice for companies to post quarterly reports and then at the end of the financial year, they give a statement on the annual reports (pre-tax and after tax).⁹

As soon as the reports are announced, the securities market react accordingly. If the reports indicate a huge turnover, then the demand for securities of the company increases rapidly and the price of the securities skyrockets.¹⁰ But if the company has posted losses, then prospective investors are discouraged from investing in such companies. Apart from that, members or security holders sell their shares/ securities at throw away prices with an aim to exit the aforesaid company.

This is the normal trend in the securities markets.

Meaning of insider trading

The affairs of the company are supposed to be kept confidential by the board, the employees and servants of the company. If there is an issue that should be communicated, the company should do so in accordance with the rules of the capital markets regulator.¹¹

Moreover, the communication should be done in public. Normally, the officers of the company possess key information regarding the financial position of the company. They are not supposed to disclose such information until at an appointed time when the company shall disclose to the public.¹² Neither are they supposed to use the information for their own financial gain unless it's made public.

The traders in the securities market are not permitted by law to gain access to such information. They are supposed to rely on the available information in the public to gauge the financial status of a company. They are required to wait until an official communication from the company is given.

However, there are rogue traders craving for quick riches who contravene the law governing the securities markets.¹³

Securities markets participants such as stock brokers have a code of ethics which governs their business. For instance, they are supposed to observe a high standard of integrity and honesty.¹⁴ The rogue traders who crave for quick riches prefer to use devious underhand methods to gain more profits as compared to their counterparts. To do so, they try as much as possible to access the information about a certain company which is not in public discourse.

They then either purchase or sell securities acting on the information they accessed before such information is made public. For instance, if the company has posted high returns, the rogue trader purchases a high number of securities of the aforesaid company before the returns are made public.

If there are losses in the company, then the trader sells all or the majority of securities he had before the information is made public. The reason why such people commit such vices is because they want to act quickly before the results of the company are made to the public in order to avoid losses or to make huge profits.

The act of gaining knowledge of the affairs of a company before they are made public and acting on such information to trade in securities markets is known as insider trading.

Insider trading in Kenya

In Kenya the provision regarding insider trading is held in section 32B of Capital Markets Act. It is defined as: "It is the dealing in listed securities or derivatives that are price affected relying on information which has not been made public... and if such information were to be made public, it could have material effect on the price of securities or derivatives."¹⁵ Insider trading entrenches the narrative that the capital market is a club for self-gain for a few devious individuals.

What is the evidentiary threshold for convicting a person for insider trading?

The judiciary has been on the receiving end for failing to convict people suspected of insider trading because it has set a high bar which the prosecution is required to meet when presenting evidence. Those involved in insider trading take extra caution to ensure their tracks are covered, therefore any investigation into such acts will yield little evidence. Most of the evidence found is superficial and circumstantial in nature. Hence, if courts do not consider circumstantial evidence but instead demand for direct evidence, then convicting

⁸ <https://www.getsmarteraboutmoney.ca/invest/investment-products/stocks/factors-that-can-affect-stock-prices/>

⁹ <https://www.investopedia.com/ask/answers/04/050604.asp>

¹⁰ <https://opentextbc.ca/principlesofeconomics/chapter/4-2-demand-and-supply-in-financial-markets/>

¹¹ shodhganga.inflibnet.ac.in/jspui/bitstream/10603/132537/11/11_chapter%204.pdf

¹² https://www.sec.gov/Archives/edgar/data/25743/.../ex14_02.htm

¹³ <https://www.nytimes.com/1995/02/28/business/the-collapse-of-barings-for-rogue-traders-yet-another-victim.html>

¹⁴ https://www.citigroup.com/citi/investor/data/codeconduct_en.pdf?ieNoCache=939

¹⁵ section 32B of Capital Markets Act

such perpetrators is highly improbable. The courts ought not to demand that the prosecution proves beyond reasonable doubt, in fact the burden of proof should be shifted to the defendant to establish that he is not involved in such vices. In short insider trading is not like any common crime where you will find direct evidence. The cases below illustrate the court's perception regarding the evidentiary threshold required to convict a person for insider trading.

Republic v. Christopher John Kirubi & 13 others

In Kenya there have been recent cases of insider trading that have shaken the nation to the core. The boards of listed companies have been on the fore front in propagating this vice.¹⁶ Uchumi supermarket is one of those companies which crumbled at the hands of its board of directors. They sold the company's securities relying on the information they had accessed in their official capacity- that the company was heading downhill. Instead of putting a mechanism in place to rectify the situation, they opted to jump ship. The captain of the ship shouldn't abandon it at the hour of need.

The fall of UCHUMI Supermarket.¹⁷

UCHUMI was a chain of supermarkets with networks all over the country. During its golden times, it was the epitome of Kenya's entrepreneurial spirit. However, the company took a downward spin engineered by its directors. In their official capacity, they sold their shares in the company long before it was disclosed to the public that the company was experiencing financial problems. Even after they had sold their shares the directors continued supplying the company with goods there by pushing it further into debt.¹⁸

When it was found out that the directors had sold their shares long time before the company's financial status had been disclosed, and they had gained huge profits from the sale, criminal charges were initiated against them.

The truth of the matter is; it is the small scale investors that suffered the most from the collapse of UCHUMI. The directors of the company did little to save the company but instead chose to make profits. They milked UCHUMI dry. The small scale investors lost a huge chunk of their investments as the company was brought to its knees.¹⁹

Interestingly, the directors of the company were acquitted and set free by the courthearing the case. They were not held responsible for what they had done.²⁰

Republic V. Terrence Davidson²¹

Mr Davidson was former chief executive officer of Kenya commercial Bank. He was also a major shareholder of UCHUMI supermarket. Before it was disclosed to the public that UCHUMI was experiencing financial problems, Davidson had already sold his 600,000 shares. He gained huge profits from his sale.²²

However, the market regulator found out that Mr. Davidson had access to undisclosed information regarding the financial status of UCHUMI and upon accessing such price affecting information, he sold his shares.

Apparently, it is the exit of major shareholders long before the disclosure of its financial status to the public that crippled UCHUMI super market. To the dismay of the small scale investor and the public in general, Mr. Davidson was acquitted of his charges.²³

The above acquittals have exposed the Kenyan law regarding insider trading.

First of all, it's hard to get proper evidence of a direct nature as the crime of insider trading is perpetrated behind the curtains and at the highest level of secrecy.

Moreover, the courts are partly to blame for not interpreting the law regarding insider trading in a more liberal manner. They insist on strict interpretation which requires direct evidence that links the suspect to the crime which is an improbable task. This is because, most evidence relating to insider trading is circumstantial, therefore it is not easy to successfully convict an accused person of this crime.²⁴

¹⁶ <https://www.theeastafrican.co.ke/business/Flaws-in-law-expose-East-Africa-bourses-to-insider-trading/2560-4837916-ijll6d/index.html>

¹⁷ <https://www.standardmedia.co.ke/article/2000189375/when-things-began-to-fall-apart-at-uchumi>

¹⁸ Republic v. Christopher John Kirubi & 13 others Cr. 900108

¹⁹ https://www.academia.edu/9132833/INSIDER_TRADING_IN_KENYA_WHO_PROTECTS_THE_OUTSIDER

²⁰ <https://www.nation.co.ke/news/1056-1168376-15ug70hz/index.html>

²¹ Republic V. Terrence Davidson 1338 of 2008 CMCC

²² <https://www.businessdailyafrica.com/markets/Court-rulings-expose-vacuum-in-war-against-insider-trading/539552-1060490-4f41i8z/index.html>

²³ <https://www.nation.co.ke/business/Davidson-freed-over-claims-of-insider-trading-/996-1060246-blw19vz/index.html>

²⁴ <https://www.theeastafrican.co.ke/business/Flaws-in-law-expose-East-Africa-bourses-to-insider-trading/2560-4837916-ijll6d/index.html>

Therefore, the small scale investor has been left in the cold while the major investors rake in huge profits while they can.

The legal provisions relating to insider trading in Kenya are not effective and as a result are not easy to enforce. There is no consensus as to what constitutes insider trading. The accused persons often take advantage of the lack of judicial consensus as to what constitutes the crime of insider trading to poke holes on the prosecution's case and in most cases, the accused persons are acquitted.

Anne Kotonya (2012) points out that; "there is a deficiency in the provisions of the existing law concerning insider trading. They lack clarity in addition to that, there are challenges in enforcing such provisions. There are no mandatory disclosure requirements. This puts all the burden of combating insider trading on the Capital Markets Authority alone."²⁵

Insider trading in India

The legal provision concerning insider trading brings out insider trading as, "dealing in trade of securities using unpublished price sensitive information or passing such unpublished price sensitive information to another person without due regard to the law or using such unpublished price sensitive information to influence other people to trade in securities."²⁶

Lately, the Securities and Exchange Board of India has been the subject of criticism for its deficiency in investigating and prosecuting of inside traders.²⁷ This is because, when a person is found guilty of the above crime, SEBI gives him a light punishment. As a result, the capital market players aren't discouraged from engaging in such unfair practices.²⁸

In addition to that, perhaps it is because SEBI has a limited personnel which implies that its work force is overwhelmed that is why there are no effective investigations that could lead to the conviction of a suspect. "Currently there are 780 employees. When one compares that ratio of SEBI's employees to the number of companies listed in the exchanges, the ratio is one employee for every six companies. On the other hand, the securities exchange commission in the United States of America has a higher number of employees. The ratio in the U.S.A is one employee per a company listed in the exchange."²⁹

The table below affirms the view of this researcher that the securities markets regulator in India takes a long period of time to complete an investigation and prosecute the accused in court. Further, the rate of conviction is dismal.

Year	Investigations taken up	Investigations completed
2010-11	28	15
2011-12	24	21
2012-13	11	14
2013-14	13	13
2014-15	10 ³⁰	15

It has been noted with a lot of concern that SEBI's investigations take a long period of time. There no clearly set period within which the investigations should be concluded.³¹

"It is the speed and efficiency of enforcement that lends credibility to any surveillance set-up."³²

²⁵ Combating insider trading in Kenya's capital markets: challenges and opportunities for reform"

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<http://erepository.uonbi.ac.ke/handle/11295/9404>

²⁶ Section 15G The Securities and Exchange Board of India Act, 1992 SEBI Act

²⁷ <https://indiacorplaw.in/2018/02/sebi-failing-regulating-insider-trading-india.html>

²⁸ ibid

²⁹ <http://www.newindianexpress.com/business/2017/oct/07/sebi-has-one-employee-for-every-six-listed-firms-1668126.html>

³⁰ <https://indiacorplaw.in/2018/02/sebi-failing-regulating-insider-trading-india.html>

³¹ J Sanyal - 2293378=tcartsbamoc.nrss.www//:sptth "smacS laicnaniF fo pordkcaB eht ni IBES fo weiver lacitirC". 2012

³² **Market Scandals and Regulatory Governance**

II. CONCLUSION

In conclusion, with the technological advancements and use of gadgets by culprits, it has become tougher to successfully convict an inside trader.³³ The courts demand that the prosecution should establish beyond reasonable doubt that the suspect has committed insider trading yet the only available evidence is circumstantial. Therefore, the best way forward is embracing of technology in combating this crime for instance possession of wiretapping gadgets to enable investigators to listen to phone calls of suspects. Further, the market regulators such as SEBI in India and CMA in Kenya should have techno-savvy human resource and artificial intelligence to enable them access evidence where perpetrators are using encrypted gadgets or encrypted applications such as WhatsApp, for instance recently, price sensitive information was shared in some WhatsApp groups in India before such information was released to the public.³⁴ Above all, the legislative arm should wake up to the reality that although accessing mobile phones, computers and other communication gadgets infringes one's right to privacy a balancing act should be made to ensure this vice is curbed and perpetrators are convicted as a deterrent. Enacting laws to provide the market regulators power to access such gadgets will provide them the much needed opportunity to build concrete prosecution cases against suspects beyond reasonable doubt hence leading to conviction of such suspects.

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³³ Bhavya Bhandari <https://indiacorplaw.in/2018/02/sebi-failing-regulating-insider-trading-india.html>

³⁴ <https://in.reuters.com/article/india-whatsapp/exclusive-prescient-messages-about-indian-companies-circulate-in-whatsapp-groups-idINKBN1DG0IQ>